

ORIGINAL

BEFORE THE
Federal Communications Commission
WASHINGTON, DC 20554

In the Matters of)
)
1998 Biennial Regulatory Review —)
Review of Depreciation Requirements for)
Incumbent Local Exchange Carriers)
)
United States Telephone Association Petition for)
Forbearance From Depreciation Regulation of)
Price Cap Local Exchange Carriers)

CC Docket No. 98-137

ASD 98-91

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SUMMARY

U S WEST concurs with the majority of the parties commenting in this proceeding and urges the Commission to remove itself completely from the prescription of depreciation rates for price cap incumbent local exchange carriers ("LECs"). Simply put, the record in this proceeding demonstrates that continued regulation of depreciation is no longer justified in law or fact, given the elimination of the sharing mechanism in the Commission's price cap regulatory program and the onset of competition in the telecommunications market.

Parties opposing depreciation deregulation assert that depreciation regulation remains necessary to ensure that price cap LECs' rates are just, reasonable, and not unreasonably discriminatory, and to protect consumers. These arguments are unsupportable. The record in this proceeding demonstrates that GAAP is sufficient to ensure that depreciable lives selected by LECs will be reasonable and appropriate. Moreover, contrary to the arguments by MCI WorldCom and AT&T, depreciation regulation is not necessary to monitor LEC price cap performance. Thus, U S WEST submits that the Commission should permit all price cap LECs to select their own depreciable lives and amortization periods in accordance with GAAP.

U S WEST opposes the Ad Hoc Telecommunication Users Committee's ("AHTC") "make whole or make money" proposal. Insofar as the AHTC is concerned about minimizing any future impact upon access rates, its concern is misplaced. Permitting LECs the flexibility to set economic depreciable lives and amortization periods will not eliminate the existing reserve deficiency, but will prevent such reserve deficiencies from developing on a going-forward basis.

Finally, U S WEST supports those commenters who urge the Commission to provide LECs the option of treating net salvage as either a current expense or a component of depreciation. The Commission should completely remove itself from establishing depreciation parameters and net salvage is one of those parameters. Insofar as mandatory elimination of net salvage may not be appropriate, however, each price cap LEC should be allowed to account for net salvage as it chooses.

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REPLY COMMENTS OF U S WEST, INC.

U S WEST, Inc. ("U S WEST") hereby submits the following reply comments in the above-captioned proceedings.¹

I. THE COMMISSION SHOULD ELIMINATE DEPRECIATION REGULATION FOR PRICE CAP LECs

The majority of the parties commenting in these proceedings agree that the Commission should remove itself completely from the prescription of depreciation rates for price cap incumbent local exchange carriers ("LECs").² Stated broadly, these parties demonstrate that continued regulation of depreciation is no longer justified in law or fact, given the elimination of the sharing mechanism in the Commission's price cap regulatory program. Dr. Robert Harris stated the situation succinctly in his Statement on Commission Depreciation Requirements.

¹ See 1998 Biennial Regulatory Review — Review of Depreciation Requirements for Incumbent Local Exchange Carriers, CC Docket No. 98-137, Notice of Proposed Rulemaking, FCC 98-170 (rel. October 14, 1998) ("Depreciation NPRM").

² See Ameritech Comments; Bell Atlantic Comments; Comments of BellSouth; Comments of Cincinnati Bell Telephone Company; Comments of GTE; Comments of Southwestern Bell Telephone Company, Pacific Bell and Nevada Bell ("SBC"); Comments of Sprint Corporation; Comments of U S WEST, Inc.; Comments of the Virginia State Corporation Commission Staff.

The era for depreciation prescription has passed. The costs in terms of time and money of depreciation prescription regulation are an unnecessary burden to both the FCC and the ILECs. Changes in Federal price cap rules are acting as a watchdog over firms' profits, thereby rendering depreciation prescription useless. Furthermore, the increasingly competitive environment is constraining depreciation practices. Traditional telephony is being challenged by new technologies that offer alternative means of communications and that are changing market incentives. The rapid pace of technological change indicates that it . . . has not only become extremely difficult to accurately prescribe depreciation lives, but also that the prescription of depreciation lives itself should be eliminated completely and ILECs must be allowed to set their own truly forward looking depreciation lives.³

U S WEST concurs and submits that the LECs should have the flexibility to set their own depreciation rates consistent with the requirements of generally accepted accounting principles ("GAAP").

To the extent that the Commission elects to continue depreciation regulation for price cap LECs, the price cap LECs note that the streamlining proposed in the *Depreciation NPRM* is inadequate — the proposals might ease the Commission's administrative burden, but would provide little relief for LECs.⁴ These parties also note that the Commission would need to conduct a comprehensive review to establish reasonable economic life ranges for all assets, not just digital switching equipment.⁵ U S WEST concurs with this position and believes that the

³ See Comments of SBC, Exhibit A, "Statement on FCC Depreciation Requirements," at 1 (November 19, 1998).

⁴ See, e.g., Comments of BellSouth at 11-12; Comments of Cincinnati Bell at 6-7; Comments of GTE at 2-3.

⁵ See, e.g., Comments of BellSouth at 12; Comments of GTE at 12-15; Comments of SBC at 20-23.

Commission would have to undertake significant incremental work to establish reasonable economic life ranges for all depreciable assets.⁶

II. COMMENTS SUPPORTING DEPRECIATION REGULATION ARE WITHOUT MERIT

Other parties, including AT&T, MCI WorldCom, Inc. ("MCI WorldCom") and the Government Services Administration ("GSA"), argue that the Commission should retain depreciation regulation and deny the United States Telephone Association's ("USTA") Petition for Forbearance from enforcement of such regulations.⁷ In the view of these parties, depreciation regulation remains necessary to ensure that price cap LECs' rates are just, reasonable, and not unreasonably discriminatory, and to protect consumers.⁸ AT&T and MCI WorldCom also argue that GAAP alone is insufficient to protect consumers from price cap LECs setting unreasonable depreciation rates.⁹ As discussed below, the arguments offered by MCI, AT&T and GSA are unsupportable and simply represent these parties' "knee-jerk" opposition to any regulatory relief for LECs, regardless of the merits.

⁶ See U S WEST Comments at 10-11.

⁷ See Comments of AT&T Corporation; Comments of the General Services Administration; Comments of MCI WorldCom, Inc.; Comments of Florida Public Service Commission.

⁸ Comments of MCI WorldCom at 3-4; Comments of AT&T at 12-20; Comments of GSA at 2-4.

⁹ Comments of MCI WorldCom at 8; Comments of AT&T at 21-22. These parties also assert that state commissions generally prescribe depreciation rates for intrastate purposes which rely strongly on the Commission-prescribed depreciation rates. Comments of AT&T at 19-20; Comments of MCI WorldCom at 6-7. U S WEST refuted this argument in its comments. As noted therein, each of the 14 states in which U S WEST operates has established depreciable lives that are different from those prescribed by the Commission. In addition, all 14 states have at least one depreciable life that is below the Commission-prescribed ranges. See U S WEST Comments at 9 n.26, 11.

A. GAAP is Sufficient to Ensure That Depreciable Lives Selected by LECs Will be Reasonable and Appropriate

AT&T and MCI WorldCom reject the LECs' argument that GAAP standards are sufficient to ensure that depreciable lives selected by LECs will be reasonable and appropriate. In their view, GAAP is designed to protect investors and the financial markets, but provides no protection for rate payers.¹⁰ Indeed, AT&T goes so far as to suggest that GAAP is governed by the principle of "conservatism" which establishes incentives for LECs to understate net income and net assets. According to AT&T, "[s]uch a measurement bias in a regulated industry . . . would lead to the establishment of excessively high depreciation rates, with consequent harm to the public."¹¹ These arguments are simply wrong.

At the outset, U S WEST notes that both AT&T and MCI WorldCom set their own depreciation lives and parameters pursuant to GAAP which enables them to set shorter depreciation lives than the Commission-prescribed ranges utilized by the LECs. Further, GAAP standards expressly state that "conservatism" does not imply an understatement of net assets and net income.

Conservatism in financial reporting should no longer connote deliberate, consistent understatement of net assets and profits. The Board emphasizes that point because conservatism has long been identified with the idea that deliberate understatement is a virtue. That notion became deeply ingrained and is still in evidence despite the efforts over the past 40 years to change it.¹²

¹⁰ See Comments of AT&T at 21-22; Comments of MCI WorldCom at 8, 19-20.

¹¹ Comments of AT&T at 21.

¹² Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 2, "Qualitative Characteristics of Accounting Information," at 10442 (1980); *see also* Kieso and Weygandt, "Intermediate Accounting, 6th Edition at 43 (John Wiley & Sons (continued...))

Furthermore, AT&T and MCI WorldCom are wrong to suggest that conservatism is the overarching, governing principle of GAAP. Indeed, Arthur Andersen, LLP (“Arthur Andersen”) specifically addresses this point in its November 10, 1998 Supplement to its Position Paper on Accounting Simplification in the Telecommunications Industry.¹³ As Arthur Andersen states, there are many guiding principles, in addition to conservatism, that underlie GAAP including: relevance (timeliness and predictive value); reliability (completeness, verifiability, and conservatism); neutrality; comparability; consistency; materiality; costs and benefits.¹⁴ It is these characteristics that “collectively serve to protect all users of financial statements prepared in accordance with GAAP. These users not only include shareholders, but [also] regulators, *ratepayers*, financial analysts and creditors, among others.”¹⁵

Moreover, U S WEST notes that a company’s compliance with GAAP standards is assured through annual audited financial statements filed with the Securities and Exchange Commission (“SEC”). In addition, publicly-traded companies such as the price cap LECs are subject to additional SEC regulation regarding financial records and disclosure, stock exchange

¹² (...continued)
1987) (stating “Note that there is nothing in the conservatism convention urging the accountant to understate assets or income . . . All that conservatism does, properly applied, is to give the accountant a guide in difficult situations, and then the guide is a very reasonable one: refrain from overstatement of net income and net assets.”); Kieso and Weygandt, “Intermediate Accounting, 9th Edition at 51 (John Wiley & Sons 1998) (stating “Note that there is nothing in the conservatism convention urging that net assets or net income be *understated*.”).

¹³ See Supplement to July 15, 1998 Position Paper, “Accounting Simplification in the Telecommunications Industry,” at 17, CC Docket Nos. 98-81, 98-117, 96-150, and ASD File No. 98-64 (filed November 10, 1998).

¹⁴ Arthur Andersen Supplement at 11-12.

¹⁵ *Id.* at 12-13 (emphasis supplied in part).

listing requirements, and to external audit on an annual basis. These ongoing oversight mechanisms ensure that a company will establish economic lives that are comparable with those of other similarly-situated companies, are within appropriate ranges for financial reporting purposes, and will not work contrary to the interests of consumers. Consequently, U S WEST submits that, contrary to the position of AT&T and MCI WorldCom, compliance with GAAP standards will not lead to the establishment of excessively high depreciation rates.

B. Depreciation Regulation Is Not Necessary to Monitor LEC Price Cap Performance

AT&T and MCI WorldCom also argue that continued depreciation regulation is necessary to “ensure effective monitoring of LEC price cap performance.”¹⁶ In support of this proposition, AT&T and MCI WorldCom assert that the fact that few LECs have utilized the low end formula adjustment demonstrates their continued market power as well as suggests that the existing productivity factor may be too low.¹⁷ In their view, allowing LECs to select their own depreciation rates would permit the LECs to set excessively high rates thereby reducing reported earnings and masking the need for a higher productivity factor.¹⁸ Again, AT&T’s and MCI WorldCom’s arguments are erroneous.

U S WEST submit that AT&T and MCI WorldCom actually have their facts backwards. To date, LEC depreciation lives have been held to uneconomic and unrealistic ranges due to unwarranted Commission regulation. Consequently, depreciation expenses as reported to the Commission have been understated, and this has fundamentally biased earnings

¹⁶ Comments of AT&T at 18; *see also* Comments of MCI WorldCom at 5.

¹⁷ *Id.*

¹⁸ *Id.*

levels. In short, AT&T and MCI are wrong — the current reported earnings levels are not indicative of either market power or a need to establish a higher productivity factor.

It is interesting to note AT&T's and MCI WorldCom's unified front on this point.¹⁹ It appears that these parties have set aside their direct competition in favor of securing competitive advantages over the LECs. MCI WorldComm states that if "the incumbent LECs were able to recover a disproportionate share of their investment from captive ratepayers, they would be able to unfairly underprice their services as potential competitors struggle for market share."²⁰

U S WEST notes in this regard that, unlike the LECs, both AT&T and MCI WorldCom are permitted to set their own depreciation lives and parameters. Moreover, AT&T's depreciable lives for switching and fiber cable are significantly shorter than the Commission-prescribed ranges utilized by the LECs. Consequently, AT&T and MCI WorldCom simply desire to secure a competitive benefit by continuing to utilize shorter depreciation periods while LECs would be required to utilize the longer Commission-mandated lives.

Contrary to AT&T's and MCI WorldCom's arguments, providing LECs the flexibility to set their own depreciation rates will not adversely affect these companies' competitive position. AT&T and MCI WorldCom are not fledgling companies struggling for market share in any telecommunications market in which they would be allowed to compete. Thus, although the Commission is properly concerned about the rates charged to AT&T and MCI

¹⁹ Indeed, the comments are unified to the point of adopting virtually identical language to make their arguments. *Compare* Comments of AT&T at 18 to Comments of MCI WorldCom at 5.

²⁰ Comments of MCI WorldCom at 21.

WorldCom, this concern does not justify granting these carriers a competitive advantage by continuing to prevent LECs from selecting their own depreciation rates. As discussed above, there are numerous regulatory safeguards other than Commission prescription which will ensure that the LECs will not “game” their depreciation lives to the detriment of their ratepayers.

Moreover, AT&T and MCI WorldCom improperly discount the fact that the onset of competition in the telecommunications market undermines any need to continue depreciation regulation. As Dr. Harris demonstrates, increasing competition necessarily shortens depreciation lives.

[B]asic economic principles dictate that when a market makes a discrete, parametric shift toward a more competitive environment - such as occurred with the passage of the Telecommunications Act of 1996 - plant and equipment will become obsolete faster as competition stirs technological innovation in equipment supply markets. The inevitable counterpart of enhanced technological progress is a more rapid rate of obsolescence for existing plant and equipment.²¹

In addition, Dr. Harris points out that competition does not have to be currently robust to change economic life estimates if competition can be estimated to occur within the life of the asset.²²

As Dr. Harris notes, however, the Commission is simply unable to account for such changing conditions in prescribing depreciation rates.²³ “Economic depreciation should fundamentally reflect forward looking competitive conditions in the market, and those conditions

²¹ Comments of SBC, Exhibit A, at 17.

²² *Id.* at 16-17.

²³ *Id.* at 18-19.

have undergone a sea-change since 1995.”²⁴ The Commission’s prescribed depreciation ranges, however, are “*undeniably backward looking* and result[] in uneconomically long depreciation lives.”²⁵ The *Depreciation NPRM* proposes retaining depreciation life ranges set in 1995, prior to the passage of the Telecommunications Act of 1996, the successful deployment of PCS, and the emergence of the Internet as a critical piece of the nation’s telecommunications infrastructure.²⁶ Simply put, the Commission’s prescribed ranges are not economic lives and should not be imposed upon price cap LECs. Thus, U S WEST submits that all price cap LECs should be free to select their own depreciable lives and amortization periods in accordance with GAAP.

III. THE AHTC’S PROPOSED “MAKE WHOLE OR MAKE MONEY” POLICY IS WITHOUT MERIT

The Ad Hoc Telecommunications Users Committee (the “AHTC”) does not oppose “in principle” the deregulation of price cap LECs’ depreciation practices and comments in support of the Commission on a number of issues presented in the *Depreciation NPRM*. The AHTC’s “bottom line” issues, however, appear to be the low end formula adjustment and LECs’ reserve deficiencies. Indeed, the AHTC states that depreciation deregulation would be in the public interest only if it is accompanied by the elimination of regulatory guarantees for the recovery of embedded investment such as the low-end formula adjustment or the right to seek recovery of reserve deficiencies.²⁷ To that end, the AHTC proposes the Commission adopt a “make whole or make money” policy framework in which LECs would have the option to accept

²⁴ *Id.* at 16.

²⁵ *Id.* at 13.

²⁶ *Id.* at 13-14.

²⁷ *See* Comments of the AHTC at 2.

a guaranteed recovery of their embedded accounting costs but retain depreciation regulation (make whole) or accept prescribed access rates with pricing flexibility and forbearance on depreciation prescription (make money).²⁸

U S WEST appreciates the superficial appeal of the AHTC's sloganism, but does not accept the premise that securing accounting flexibility must be premised upon surrender of specific guaranteed legal rights which are not at issue in this proceeding. Moreover, U S WEST believes that to the extent the AHTC is concerned about minimizing any future impact upon access rates, its concern is misplaced. As U S WEST noted in its comments, permitting LECs the flexibility to set economic depreciable lives and amortization periods will not eliminate the existing reserve deficiency.²⁹ It would, however, prevent such enormous reserve deficiencies from developing on a going-forward basis, thereby limiting any incremental impact upon access rates.³⁰

IV. THE COMMISSION SHOULD PROVIDE LECs FLEXIBILITY WITH REGARD TO NET SALVAGE

The *Depreciation NPRM* proposes either to: (1) eliminate the future net salvage factor from the depreciation calculation, instead recording salvage and cost of removal as a current expense; or (2) allow LECs the option of treating net salvage as either a current period expense or a component in the depreciation calculation.³¹ U S WEST concurs with those com-

²⁸ *Id.* at 13-14.

²⁹ *See* Comments of U S WEST at 11.

³⁰ *Id.*

³¹ *Depreciation NPRM* at ¶ 14.

menters who support providing LECs the option of treating net salvage as either a current expense or a component of depreciation.³²

As noted above, U S WEST believes that the Commission should eliminate all depreciation regulation, including regulation over net salvage. As other commenters have noted, however, mandatory elimination of the net salvage factor from the depreciation formula is not appropriate. The Financial Accounting Standards Board ("FASB") is still working on official accounting principles for liabilities related to the closure and removal of long-lived assets.³³ This does not mean, however, that the Commission should continue regulation of net salvage. Instead, the Commission should provide LECs the option to treat net salvage as either a current expense or a component of depreciation.

CONCLUSION

For the reasons stated above and in the comments filed in this proceeding, U S WEST submits that the Commission should eliminate depreciation regulation for price cap


³² See Comments of Cincinnati Bell at 8-9; Comments of GTE at 18-19; Comments of SBC at 27-28.

³³ *Id.*

LECs. There is simply no justification in law or fact for continuing to deny price cap LECs the flexibility to set their own depreciable lives and amortization periods in accordance with GAAP.

Respectfully submitted,

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I, Shelia L. Smith, hereby certify that on this 8th day of December 1998, copies of the foregoing Reply Comments of U S WEST, Inc. were served on the following by U.S. first-class, postage-prepaid mail:

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